

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

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PLR-125698-10

Date:
November 10, 2010

LEGEND:

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|--------------|---|
| Taxpayer | = |
| Parent | = |
| State | = |
| Commission A | = |
| Commission B | = |
| Commission C | = |
| Order A | = |
| Date A | = |
| Order B | = |
| Date B | = |
| Year X | = |
| Year Y | = |
| Year Z | = |
| Year | = |
| Director | = |

Dear :

This letter responds to Taxpayer's request, dated June 18, 2010, for a ruling on the consequences of Taxpayer's accounting and regulatory treatment of the Investment Tax Credit (ITC).

The representations set out in your letter follow.

Taxpayer is a public utility incorporated in State. It is a wholly-owned subsidiary of Parent, also incorporated in State, and is included in the consolidated federal income tax return of Parent. Taxpayer is principally engaged in providing electric, gas, and steam service and is regulated with respect to the terms and conditions of service and, most particularly, regarding the rates it may charge for its services by Commission A, Commission B, and Commission C. With respect to the jurisdiction of each of the commissions, Taxpayer's rates are determined using a cost of service basis that allow Taxpayer to earn a reasonable rate of return.

Taxpayer's rate base with respect to property is recovered over time using an estimated useful life of the assets as determined by the various Commissions. Taxpayer periodically conducts depreciation studies that may result in changing the estimated life of certain property. In addition, where property has generated an ITC, Taxpayer has elected to account for its ITC pursuant to former § 46(f)(2) of the Internal Revenue Code. Under that section, Taxpayer reduces its cost of service by amortizing the ITC ratably over the estimated life of the property.

Commission A, in Order A (issued on Date A), adopted the full normalization method of accounting for deferred income taxes. The rules adopted by Commission B require that utilities under its jurisdiction compute the income tax component of cost of service by using tax normalization. Commission C, in Order B (issued on Date B) affirmed Taxpayer's deferred income tax accounting including tax normalization and permitted Taxpayer to follow the deferred tax accounting approved by Commission A. Thus, each of the three commissions regulating Taxpayer have a long-established practice of requiring utilities to normalize their ITC and related tax consequences.

Taxpayer, during the preparation of financial statements for Year, has discovered that, when it extended the useful life of certain assets as a result of depreciation studies conducted in Year X, Year Y, and Year Z, it failed to extend the amortization period for the Accumulated Deferred Investment Tax Credit (ADITC). This resulted in flowing to ratepayers the benefits of the ITC more rapidly than permitted by the normalization rules. Taxpayer immediately notified each of the Commissions of this matter. Each of the Commissions had previously relied upon calculations of ITC by Taxpayer, accepting such schedules as presented by Taxpayer as representing the correct treatment by Taxpayer of ITC as required by the Commissions. Taxpayer was able to make the necessary corrections in a rate case before Commission C. The Taxpayer has informed Commission A of the erroneous treatment and Commission A has agreed to adjust the amortization period for the ADITC so that the remaining ADITC will be returned to ratepayers over the appropriate remaining life of the assets as necessary. Rate case filings with Commission B follow the accounting as with Commission A and so future rate adjustments in the current proceeding before Commission B will follow the correcting treatment of Commission A.

Law and Analysis

Former section 46(f)(2) of the Code provides an election for ratable flow through under which an elector may flow through the investment tax credit to cost of service. However, former 46(f)(2)(A) provides that no investment tax credit is available if the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit determined under former 46(a) and allowable by section 38. Also, under former section 46(f)(2)(B) no investment tax credit is available if the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit determined under former 46(a) and allowable by section 38.

Former section 46(f)(6) of the Code provides that for purposes of determining ratable portions under former section 46(f)(2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

Under section 1.46-6(g)(2) of the regulations, "ratable" for purposes of former section 46(f)(2) of the Code is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. Regulated depreciation expense is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes.

Section 1.46-6(f)(4) provides that the ITC is disallowed for any section 46(f) property placed in service by a taxpayer before the date a final decision of a regulatory body that is inconsistent with section 1.46-6(f)(2) is put into effect on or after such date and before the date a subsequent decision consistent with section 1.46-6(f)(2) is put into effect.

Section 1.46-6(f)(2) provides that there is no disallowance of a credit before the first final inconsistent determination is put into effect for the taxpayer's § 46(f) property.

Section 1.46-6(f)(8)(1) provides that "inconsistent" refers to a determination that is inconsistent with § 46(f)(1) or (2). For example, a determination to reduce the taxpayer's cost of service by more than a ratable portion of the credit would be a determination that is inconsistent with § 46(f)(2).

Senate Report No. 94-36, 94th Cong., 1st Sess. 44-45 (1975), 1975-1 C.B. 590, 610, provides, in its explanation of the ratemaking treatment to be accorded the additional ITC allowed public utilities under the 1975 Act, explains that the additional ITC is to be disallowed if the regulatory agency requires the flowing-through of a company's additional ITC at a rate faster than permitted, or insists upon a greater rate

base adjustment than is permitted, but only after a final determination is put into effect. That report further provides that the rules provided under existing law with respect to determinations made by a regulatory body and the finality of its orders would apply to this provision.

Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581, provides, in its explanation of amendments to the Revenue Act of 1971 dealing with the limitations on the ratemaking treatment of the ITC under section 46(e)(1) and (e)(2), that the Committee hopes that the sanctions of disallowance of the ITC will not have to be imposed.

Taxpayer erroneously failed to extend the amortization period for the Accumulated Deferred Investment Tax Credit (ADITC) while extending the useful life of certain assets as a result of its depreciation studies. The practical effect of this error was to lower rates and thus, to flow the ITC to its customers slightly more rapidly than if the amortization period had correctly been extended as well. Rates were approved by each of the Commissions based in part on this error. However, this reduction in rates was not the intent of either the Taxpayer or the Commissions. Further, Taxpayer has acted upon discovery of this error, adjusting its rates when it had an open case and ensuring that rates approved by the other Commissions will be determined using the correct useful life in the future. We conclude that Taxpayer's actions as described above are not inconsistent with the requirements of former § 46(f). Finally, none of the Commissions specifically considered the calculation of ADITC by Taxpayer in any rate case and so did not make a determination inconsistent with § 46(f)(2) and the regulations thereunder. In accord with the Senate Reports quoted above, disallowance or recapture of the ITC should be imposed only after a regulatory body has required or insisted upon such inconsistent treatment by a utility. Because the Commissions did not insist on the errors discussed above, no disallowance or recapture is required in this case.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. In particular, orders concerning this matter finalized by any of the Commissions after the date of this ruling are not necessarily subject to the same analysis as those considered above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

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Sincerely,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
(Passthroughs & Special Industries)